This outdated functional form is too restrictive for this kind of analysis and has been replaced by a series of much less restrictive forms.[48] Although it is not clear how significant the bias is from the use of the Cobb Douglas model, it is clear that the analysis involves simplified assumptions dating back over 60 years.

Finally, the Godwins Report ignores *the usual uncertainty that is associated with survey results measured by calculated standard errors*. As we discussed, Godwins utilized data from a survey of 830 employers who sponsor post-retirement plans and 170 employers who do not. It is a well accepted fact that data from surveys are subject to uncertainty which is usually measured by the standard error.[49] However, these standard errors are never taken into account in the calculation of the Benefit Level Indicators (BLIs). Thus the data shown in the table on page 28 of the Godwins report assumes that the standard deviation is zero. This is obviously incorrect. Furthermore, there is no information as to the variance or the standard deviation of the sample data so that the sensitivity of the results can be analyzed. Combined with the fatal errors discussed above, this shows a report which was designed to come to a particular conclusion favorable to the LECs.

Overall, the Godwins model has numerous serious flaws which render it useless for estimating the effects of FAS 106 on GNPPI and the LECs, even if one assumed that it was appropriate to make such an exogenous adjustment. We are not aware of any situation where a theoretical mathematical model like Godwins's has been combined with hypothetical data to make large scale million dollar policy decisions.

The NERA Report

The basic theme of the NERA report is that FAS 106 will increase LEC costs in ways which will not be totally captured in the GNPPI. Specifically, the NERA report claims that Pacific Bell's Price Cap should be increased by 1.92% to account for alleged FAS 106 costs. NERA argues that the FCC should grant relief for this non-GNPPI "cost increase" via a "Z"-adjustment in the price caps formula. The NERA report — although very different (and even contradictory) to the Godwins Report, nevertheless contains several fatal flaws which make it useless for estimating the effects of FAS 106 implementation.

---

48. See, for example, Berndt, *op. cit.*, chapter 9 where the Translog and other forms are discussed.

49. See, for example, J. Kmenta, *op. cit.*, Section 4.3

Of course, as with the Godwins Report no economic cost increase actually occurs when FAS 106 becomes effective. In fact, the accountants are simply changing the balance sheet presentation of certain "promises" to employees after retirement. To further complicate matters, NERA argues that the FAS 106 accounting change will not affect other companies covering some 90% of the US Gross National Product. It is impossible to believe that this accounting change could have real effects for one small category of firms and yet not affect the rest of the economy. Nowhere in the Report does NERA provide an analysis which clearly and convincingly shows that the LECs should be allowed this kind of "cost plus behavior" within a framework which is supposed to promote the kind of incentive behavior discussed by the FCC in the LEC price caps Order. Furthermore, nowhere does the NERA report clearly establish that an actual cost (which has not already been discounted) will occur.

Additionally, the very assumption by NERA that there exists a well-defined "cost-plus sector" of the economy (whether or not it is 10% of the total) is fatuous. NERA includes regulated utilities and defense contracting firms in the supposed sector. The Commission has already taken note that some kinds of defense industry contracts may incur exactly the types of incentive eliminating effects that price caps was supposed to stifle.[50] Recognizing the same counter-efficiency properties of cost-plus contracts, the military services and other Department of Defense procurement agencies have moved away from such practices. This effectively curtails the size of NERA's supposed "cost-plus" sector. More significantly, most of the remaining members of this exclusive club are regulated electric, gas and telephone public utility companies. NERA simply assumes that each of these regulated companies would be permitted to pass on FAS 106 effects, and makes no attempt at all to show that, in fact, such ratemaking treatments has been afforded such entities consistent with SFAS 71.

FAS 71 exceptions with respect to ratemaking treatment of FAS 106 or any other inter-period accruals must be overcome by any public utility that wants to reflect these future costs in current ratemaking revenue requirements and price levels. The Summary of FAS 71 states that the:

> Statement may require that a cost be accounted for in a different manner from that required by another authoritative pronouncement. In that case, this Statement is to be followed because it reflects the economic effects of the ratemaking process -- effects not considered in other authoritative pronouncements.

50. *See Further Notice of Proposed Rulemaking*, at paragraphs 43, 72-75.

The Appendix references for FAS 71 clearly note that it may be applied to accounting effects other than the specific effects that were the subject of a pronouncement in December 1982 when the Statement was issued. "If the regulated enterprise changes accounting methods and the change does not affect costs that are allowable for ratemaking purposes, the regulated enterprise would apply the change in the same manner as would an unregulated enterprise."[51] If most unregulated enterprises will explicitly reflect their actuarial estimates of FAS 106 effects only on their balance sheets, but only implicitly reflect PBOPs in their long run prices, the Commission's denial of an exogenous adjustment for FAS 106 would effectively "apply the change in the same manner" as contemplated by FAS 71. In short, the existence of a "cost-plus" sector of the economy is a major factual contention which NERA should have tried to prove — not simply assume.

However, even if the NERA report had provided a factual basis for its supposition about a "cost-plus" sector of the economy, and even if one accepts the premise that the FCC intended to pass-on such changes via exogenous adjustments — a premise entirely at odds with the Commission's statements discussed above — the NERA report is so flawed that it can contribute nothing substantive or useful to the FAS 106 debate. Flaws in the NERA report, individually and cumulatively, demonstrate that the FCC should give no consideration to the NERA report. These include:

1. NERA erroneously (and incredibly) assumes that a 1.96% increase in the prices of their "cost plus" sector which accounts for some 10% of GNP would have no effect on prices of the other sectors in the economy. This would have a definite impact on GNPPI both in the current and continuing years as the price increases flowed through the economy.

2. NERA advocates changing prices that were used in the development of the 3.3 productivity offset; this would require adjustment of all of the data used in Appendix C of the *LEC Price Caps Order* and productivity offset.

3. NERA provides no econometric or statistical estimates of the effect of implementation of FAS 106, or any parameter estimates, summary statistics, or assessments of the forecast accuracy of any model. Thus the burden of proof referenced in paragraph 16 of the Order is clearly not met.

---

51. FAS 71, Appendix B, paragraph 31.

4. NERA ignores the fact that if FAS 106 costs can be passed on directly to ratepayers in the cost plus sector, all employers (and their bargaining units) in the cost plus sector would migrate toward 100% PBOP coverage in the entire cost plus sector. This would have the effect of increasing requests for additional exogenous treatment in future years and would certainly create an additional increment to US inflation rates, especially in the health care area at just the time when national policy is to slow such inflation.

5. Last, but perhaps not least, NERA erroneously develops and proclaims universal a "theory of price cap regulation" in order to promote its own price cap views. The Commission should not rely on any aspect of this presumptuous mathematical exercise.

NERA erroneously assumes that a 1.96% price increase in 10% of GNP will have little or no effect on GNPPI. In the NERA view, there are two sectors of the economy: the cost plus sector is comprised of telecommunications, railroads, passenger transit, non-gas pipelines, electric/gas/water, and government contractors. The "other" sector is comprised of all other firms. Table 1, page 30, of the report shows that the cost-plus sector is about 10.49% of US GNP. In one of their scenarios, NERA's authors entertain the possibility that all cost plus firms increase costs by 1.92%. Their calculation of the overall effect on the price level, say GNPPI, is a final increase of 0.2% [52].

Does this make sense? Although their multiplication is fine, the report missed a rather large economic effect. The "other" sector, the non-"cost plus" firms all buy heavily from the industries shown above, especially telecommunications. Since these business would incur 1.96% price increases using NERA's scenario under exogenous treatment of FAS 106, these "other" sector firms would have cost increases some of which they would pass on to the ultimate customers. Of course all of this inflation would eventually work its way into the GNPPI and the LECs would be afforded another opportunity to increase prices. Where did NERA's analysis go wrong? For onething, the report assumed that the "other" sector buys nothing at all from the cost plus sector. Examination of the industries in that sector make it clear that this assumption is absurd.

---

52. See their calculations in footnote 33 of the NERA Report.

Economists generally discuss such effects in input-output models[53]; somehow this issue was totally ignored by NERA.

NERA advocates changing prices that were used in the development of the 3.3 productivity offset; this would require adjustment of all of the data used to develop the LEC price caps formulae. One of NERA's arguments is that "Prices under price caps were initially set using cash accounting for postretirement benefits. Thus a change in the price cap is necessary so that prices will reflect the economic cost of service."[54] The bottom line of their argument is that prices used by the FCC were wrong and should be adjusted. If the prices were wrong, then all of the analysis of Appendix C by Frentrup and Uretsky in the *LEC Price Caps Order* is wrong and the calculation of the 3.3% and 4.3% offsets are in error.

This is even further confused by the VEBA expenses recorded by Pacific in the pre-price caps time period. These numbers, by definition, affected data used to develop the 3.3% productivity offset.

If the FCC accepts NERA's argument, then the whole price cap formula must be re-analyzed and recalculated (especially the productivity offset) in order to be consistent. We believe that the FCC does not wish to re-litigate the issues in Docket 87-313 again. In order to be consistent, the request for exogenous treatment of PBOP's must be denied.

No econometric or statistical estimates of the magnitudes involved are presented; rather it provides a simplistic "back of the envelope" calculation. In contrast to the USTA report, which developed a useless and complicated economic model with invented numerical parameters, NERA presents an overly simplified calculation based on 3 numbers.[55] When energy price increases occurred, realistic econometric models are able to show the effects on overall inflation and many sectors of the economy. The same is true of various tax changes, money supply changes, and other similar economic effects. These kinds of effects are typically analyzed with the help of an econometric model of the economy. NERA has explicitly chosen not to analyze the effects of FAS 106 in this way.

---

53. See, for example, A. Chaing, *Fundamental Methods of Mathematical Economics*, Third Edition, New York: McGraw-Hill, 1988.

54. NERA Report, page 2.

55. NERA Report, pp. 26-27.

It is not possible to believe that the effects of FAS 106, if there is any effect at all, can be analyzed with three numbers.

The Report ignores effects of the proposed exogenous treatment on the extent of PBOPs. NERA completely ignores the fact that if PBOP costs can be passed on directly to ratepayers in the cost plus sector, that all employers (and their bargaining units) in the cost plus sector would migrate toward 100% PBOP coverage in the entire cost plus sector. This would have the effect of increasing health care cost inflation which would certainly create an additional increment to US inflation rates. At the same time telecommunications carriers would file requests for additional exogenous treatment in future years. This would, if accepted by the regulators, create substantial price effects.

Why would this occur? Suppose a telecommunications carrier offers two kinds of compensation to its employees: cash wages and PBOPs. The employee rightly considers both as compensation and places value on both components. If FAS 106 is afforded exogenous treatment under price caps, the employer can pass on directly to the ratepayers the PBOP differentials claimed by the LECs. Thus there is an incentive by the employer to increase PBOP coverage because it is far less costly to the employer than increases in cash wages which can not be passed on at all. The employer could then petition state commissions for "exogenous treatment". NERA completely ignores this effect which would encourage "cost-plus" behavior in an incentive regulation program which has the opposite objective.

Finally, *NERA erroneously develops an incorrect "theory of price cap regulation" which it uses to promote the LECs' biased price cap views.* In large sections of its report, NERA attempts to lend weight to its argument by including numerous pages of mathematics of a "theory of price cap regulation".[56] These 10 pages of equations do not support their position and in fact have some serious flaws. For example, the report continues to rely on equation (1) on page 7 to discuss productivity even though it assumes that the company's rate of return is constant over the time period of the analysis. This assumption is obviously incorrect as noted in testimony filed in Docket 87-313.[57]

---

56. Pages 5-9, and Appendix, pages 1-4.

57. See, for example, page 12 of "Technical and Data Errors in the FCC's Productivity Analysis", Attachment B, *Comments in Response to Supplemental Notice of Proposed Rulemaking*, Ad Hoc Telecommunications Users Committee, May 7, 1990, Docket CC-87-313.

In fact, NERA's facts and formulas are inconsistent with their own analysis of Pacific Bell's experience in California. In Docket 87-313, this same approach led Bellcore and, later, NERA to conclude that telephone industry differential productivity growth averaged 2% or less per year and that this number should be used in the FCC's price cap formula. At the same time, Pacific Bell (and GTE California) also argued that no "productivity" offset any higher than 2% should be approved in the price caps component of the California PUC's "new regulatory framework" (NRF). The California Commission adopted a 4.5% offset.[58]Now, however, Pacific Bell has requested a continuation of its 4.5% total factor productivity (TFP) growth in its California intrastate Incentive Regulation Plan called New Regulatory Framework (NRF). NERA's own conclusion is:

> By themselves, Pacific's earnings during the NRF do not suggest that a productivity target of 4.5 percent is either significantly too high or too low. While not reaching the sharing level, Pacific's earnings were consistent with an average productivity achievement over the period within the range contemplated in the Commission's Decision.[59]

The formulas which misled NERA in Docket 87-313 should not now be used to justify PBOP exogenous treatment. Overall, the NERA approach has numerous serious flaws which render it useless for estimating the effects of FAS 106 on GNPPI and the LECs, even if one assumed that it was appropriate to make such an exogenous adjustment. The FCC should give the NERA report no weight in its analysis of the LECs' claim.

IV. Conclusion

The local exchange carrier industry's efforts to have FAS 106 accounting changes applied as an exogenous Z-adjustment to the ceilings for their interstate price cap rates should be rejected by the Commission. Exogenous treatment of these accounting effects would be a very bad policy choice. The entire context of the Commission's Price Cap plan for LECs is to eliminate regulatory issues of precisely the types raised by the FAS 106 issue. The LECs' FAS 106 "cost" estimates are built upon a series of assumptions that is impossible for the FCC or any other entity to accurately audit. Granting exogenous treatment to FAS 106 effects would turn price caps into purely a "heads-we-win, tails-you-lose" for monopoly telephone companies.

---

58. Re: Alternative Regulatory Frameworks, *Decision 89-10-031*, October 12, 1989.

59. William E. Taylor and Timothy J. Tardiff, NERA, "The New Regulatory Framework 1990-1992: An Economic Review" , May, 1992, page 29.

In addition to the core policy issue raised by the proposals, we have now shown conclusively that the data and studies used to support the LECs' tariff filings and the direct cases does not accurately reflect the economic consequences of Postretirement benefits. Estimates of FAS 106 accounting effects are based upon actuarial forecasts and techniques that may not have been fully tested by the accounting profession, for telephone companies or, indeed, for other US firms. There is no supervening requirement that would provide an independent check upon these estimates because PBOPs are not governed by a separate regulatory statute, unlike Pension Plans that are regulated under ERISA. The carriers' analyses ignore the extent to which PBOP liabilities were reflected in the share prices of the LEC and other firms evaluated by the FCC for the rate of return represcription upon which the LEC price cap plan was based. Given the amount of data that was available for the modelling efforts noted above, the Commission should fairly conclude that FAS 106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers. The LECs submissions also would ignore the inter-relationships between employee compensation and benefits, including PBOPs, and the savings that would occur through the employee reduction plans now underway. Such offsetting efficiencies can continue to occur in the future, as the Price Cap plan was designed to encourage. Finally, we have shown that the "models" of the overall economic effects of FAS 106 are simplistic and inaccurate and contain assumptions about methods, data and forecasting that are not correct.

Wall Street Journal June 17, 1992 Page B4

INDUSTRY FOCUS

Changing Market Forces Baby Bells to Clean House

Companies Shuffle Management and Reorganize Operations to Keep Up

By MARY LU CARNEVALE
Staff Reporter of THE WALL STREET JOURNAL

With competition to their monopoly phone businesses looming, the seven Baby Bells are scrambling to reorganize.

Stodgy **Ameritech** Corp., based in Chicago, dropped a bombshell two weeks ago: Four top executives were leaving and more changes are expected. **Pacific Telesis Group**, San Francisco, created a similar stir two months ago when it said that it is studying spinning off its phone business. At **Bell Atlantic** Corp., Philadelphia, two top officers announced retirements this year, and an overhaul is in the works.

Yesterday, Bell Atlantic announced that its president, Anton J. Campanella, will retire June 30. Most of his duties will be divided between Robert M. Valentini and James G. Cullen, the heads of two of Bell Atlantic's local operating units.

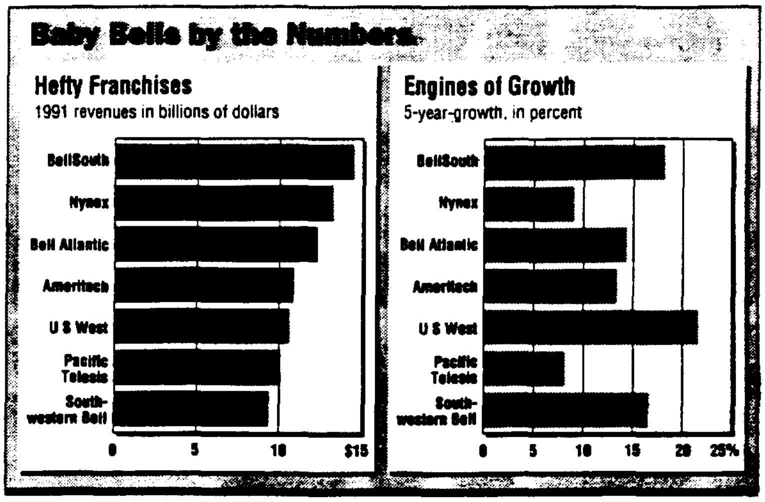
Nynex Corp., White Plains, N.Y., last year separated its phone operations from its cellular and international businesses, shuffling officers in the process. **BellSouth** Corp., Atlanta, U S West Inc., Englewood, Colo., and **Southwestern Bell** Corp., St. Louis, have done some streamlining and are studying further action.

Propelling these changes is a rapidly developing array of technologies, business alliances and communications networks and services that blur the distinctions among suppliers, customers and competitors. About 100 companies are testing pocket-phone technologies that one day could provide basic phone service. Long-distance carriers are increasingly using fiber-optic companies that link big companies to long-distance networks and are challenging local phone companies' lock on the toll-call business.

'Network of Networks'

Even old telephone hands find the scope of change staggering. "What we will have is a network of networks, and even though the networks will be integrated, they will be competitive," says William Weiss, the Ameritech chairman who ordered the executive housecleaning two weeks ago. "If we don't have people who are comfortable with that, they are going to fail," he says.

"Ameritech knows it has to change," says Daniel Reingold, a telecommunications analyst for Morgan Stanley.



Marion Boucher, an analyst for Donaldson, Lufkin & Jenrette, says that "Ameritech might embolden others to clean house." Too many Bell executives, she says, aren't up to the task of running a competitive business. "They must change," she says, "because their playing field is being rapidly leveled." She argues that their debt ratings may be too high given likely market-share erosion and uncertain regulatory changes.

Over the next few years, analysts say the monopoly phone companies can expect an assault similar to the one **American Telephone & Telegraph** Co. endured throughout the '70s and '80s, when its share of the long-distance market plunged to 65% from nearly 100%. In fact, competition from MCI Communications led to the 1984 AT&T breakup. For local phone companies, the battle initially will be over the $20 billion high-margin business of connecting long-distance carriers and big business customers to the local phone network. The challengers are upstarts such as **Teleport Communications Group** and **Metropolitan Fiber Systems** Inc., which operate fiber-optic loops in the nation's biggest cities.

"For the first time, the alternative carriers have access to capital, and they have the regulatory wind at their backs," says Jack Grubman, a telecommunications analyst for PaineWebber Inc. Two big cable companies, **Tele-Communications** Inc. and Cox **Enterprises** Inc., are in the process of buying Teleport.

At the same time, federal regulators are expected this summer to adopt rules that will fuel competitors' growth.

Today, however, the seven Bell companies, whose total revenues last year approached $80 billion, dwarf their competitors. The Bells are scanning the skies, trying to spot new forms of competition, to evaluate the threats and to respond quickly, says Steven Permut, a New Haven, Conn., marketing consultant who has worked for the Bells.

The Bells have relied on seminars and special programs to awaken managers' competitive instincts. Managers at Bell Atlantic and Nynex, for example, have attended training programs developed by Los Angeles-based **Senn-Delaney Leadership Consulting Group**.

Mr. Weiss at Ameritech turned to Noel Tichy, a University of Michigan professor who worked with **General Electric** Co. Chairman Jack Welch on his company's makeover. Mr. Tichy says he believes in extraordinary action to revive a complacent company, and many top Bell executives appear to agree.

But in their zeal to streamline, the Bells risk losing top-notch managers. "If Ameritech lets talent like that walk, it certainly could compound its problems," says Mr. Permut. Ameritech's shakeup included the early retirements of Robert Barnett, the president of the company's phone group, whom many viewed as Mr. Weiss's likely heir; Harold D'Orazio, head of Ameritech Services, a support organization for the phone companies; and Bruce DeMaeyer, head of Ameritech Mobile Communications.

Losing Baby Fat

The challenge for all seven phone companies is to lose their baby fat and become more responsive to customers, so they have abandoned the tacit promises of long, stable careers. About 40 top executives at the seven companies have retired or resigned in the past two years. Bell Atlantic is considering eliminating the position of president after their current president retires June 30.

At the same time, all the Bells are offering generous incentives to take early retirement or to resign. Southwestern Bell was fairly typical, trimming 3,700 managers last year.

The companies lately have turned to cheaper and more targeted trimming. Nynex, for example, adopted an involuntary plan to cut 3,400 managers over the next year or so. Collective bargaining this summer at six of the companies is likely to add to the toll. Nynex, which reached an early agreement with its unions, eliminated 7,000 union jobs last year.

The companies are also learning, albeit slowly, to respond to pressures from competitors and customers. At Nynex's New York Telephone unit — the first to taste significant competition from companies that offer fiber-optic connections for big businesses and long-distance carriers — employees have halved the time it takes to install high-capacity service for big customers.

Outsiders Are In

The companies are taking another uncharacteristic step: hiring outsiders, primarily for their marketing skills and strategic guidance. At Nynex, Jeffrey Rubin, a Combustion Engineering Inc. executive, was named its vice president for finance, and Thomas Tauke, a former Republican congressman from Iowa, was chosen to head its Washington office.

"In the past, we'd never do that," says Nynex's Mr. Sacco. "Now, hiring from the outside is an option we examine every time we have a position to fill."

CERTIFICATE OF SERVICE

I, Roberta Schrock, hereby certify that on this 1st day of July, 1992, copies of the foregoing document were sent by first class mail, postage prepaid, to the following:

Cheryl Tritt, Chief*
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 500
Washington, D.C. 20554

Gregory J. Vogt, Chief*
Tariff Division
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554

Colleen Boothby*
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554

Daniel Grosh*
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554

Mary Brown*
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554

James P. Tuthill
John W. Bogy
Pacific Bell
Room 1530-A
140 New Montgomery Street
San Francisco, California 94105

James L. Wurtz
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Floyd S. Keene
Barbara J. Kern
Ameritech
2000 W. Ameritech Center Drive
Room 4H88
Hoffman Estates, IL 60196-1025

Lesile A. Vial
Sherry F. Bellamy
Bell Atlantic
1710 H Street, N.W.
Eighth Floor
Washington, D.C. 20006

Durward D. Dupre
Richard C. Hartgrove
Thomas A. Pajda
Southwestern Bell Telephone
1010 Pine Street, Room 2114
St. Louis, Missouri 63101

William B. Barfield
M. Robert Sutherland
BellSouth Telecommunications
1155 Peachtree Street, N.E.
Suite 1800
Atlanta, Georgia 30367-6000

Mary McDermott
Campbell L. Ayling
Joseph Di Bella
NYNEX
120 Bloomingdale Road
White Plains, New York 10605

Downtown Copy Center*
1919 M Street, N.W., Room 246
Washington, D.C. 20554

---

* via Hand Delivery

Lawrence E. Sarjeant
James T. Hannon
US West Communications, Inc.
1020 Nineteenth St., N.W.
Suite 700
Washington, D.C. 20036

Jay C. Keithley
United Telephone Companies
1850 M Street, N.W.
Suite 1100
Washington, D.C. 20036

Craig T. Smith
United Telephone Companies
P. O. Box 11315
Kansas City, Missouri 64112

Linda D. Hershman
Southern New England Telephone Co.
227 Church Street
New Haven, Connecticut 06506

Richard McKenna
GTE Service Corporation
HQE03J36
P. O. Box 152092
Irving Texas 75015-2092

Gail L. Polivy
GTE Service Corporation
1850 M Street, N.W.
Suite 1200
Washington, D.C. 20036

Josephine S. Trubek
Rochester Telephone Corporation
180 South Clinton Avenue
Rochester, New York 14646

Roberta Schrock

Roberta Schrock